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ECONOMIC OUTLOOK

Chamber of Commerce of the United States

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THE NEAR TERM OUTLOOK

by

Graciela Testa-Ortiz and Richard W. Rahn

The third quarter GNP growth figures were revised upwards by a full percentage point, bringing the economy's growth rate to 4.3 percent, the first time since the last quarter of 1984 that GNP growth reached the 4.0 to 4.5 percent range. The revisions reinforced the sources of strength during the quarter as both consumer durable spending and federal government purchases were increased, rising by 23.3 percent and 40.9 percent, respectively. Exports remained flat during the third quarter, but imports rose by 11.1 percent pushing real net exports to a $38 billion deficit. Investment, though slightly improved from the preliminary estimate, remained negative. Real business inventories rose by $2.5 billion rather than declining by $2.1 billion as had been originally reported. Residential investment rose by almost 12 percent, however, nonresidential declined by 3.8 percent.

Save for the incorporation of recently released data, our December forecast for the next two years remains largely unchanged from last month. The sharp slowdown in domestic car sales anticipated in the aftermath of the late summer sales incentives has already become apparent. Car sales averaged 6.3 million units in October and 6.5 million in November compared to an average of 8.7 million units during the first nine months of the year. Early December data are more encouraging as sales pierced the 7 million unit level for the first time since the financial incentives were discontinued. We expect that they will average only 6.8 million for the fourth quarter, contributing to a 19 percent decline in consumer durable spending. October consumer spending data already point to the depressing effect of the fall off in domestic automobile purchases. Personal consumption expenditures declined by 0.9 percent in October compared to increases of 1.1 percent and 1.2 percent in August and September, respectively. However, an examination of the detailed data shows that consumer demand remains strong. Almost all of the decline resulted from a 22.6 percent drop in the motor vehicles and parts component which pushed durable purchases down by almost 11 percent compared to the previous month. Spending on nondurables and services, on the other hand, rose significantly. In spite of the October decline, total consumption remains seven percent above the level reached in October 1984.

The consumer spending outlook remains bright. Personal income rose in October, recording its strongest gain in six months. The rise in personal income included an 11 percent increase in farm income and a 0.5 percent increase in wage and salary disbursements in the manufacturing sector, which had remained flat during the past six months. Personal income, particularly the wages and salaries component, should strengthen further in November to reflect improvements in employment. Civilian employment rose by 62,000 in November pushing the unemployment rate down to seven percent. The good news on the employment and income front is reflected in both consumer attitudes and retail sales. The University of Michigan consumer sentiment index rose to 90.9 in November from 88.4 in October. The November gain stemmed from improved prospects for the economy, with fewer participants anticipating increases in unemployment, inflation, or interest rates over the next 12 months. Retail sales increased by 1.2 percent in November following a 3.3 percent decrease in October and are now 5.1 percent higher than at this time last year. Largely as a result of the fall off in automobile purchases, we expect fourth quarter consumer spending to decline by 0.9 percent. However, this represents a one-time adjustment as we anticipate that consumer spending will continue to be a source of strength during the next two years.

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TABLE I
UNITED STATES ECONOMIC OUTLOOK 1984-1987
Prepared by the U.S. Chamber of Commerce
Percent change from previous period at seasonally adjusted annual rates

	QUARTERS									YEARS			
	Actual			Forecast						Actual	Forecast		
	85:1	85:2	85:3	85:4	86:1	86:2	86:3	86:4	87:1	1984	1985	1986	1987
GROSS NATIONAL PRODUCT													
Real GNP	0.3	1.9	4.3	2.5	3.8	4.0	4.2	4.6	4.1	6.8	2.5	3.6	3.9
Consumption	5.2	4.9	5.3	-0.9	3.7	2.9	2.6	2.4	2.3	5.3	4.0	2.7	2.4
Residential Investment	5.5	6.1	11.6	6.0	8.5	8.0	7.4	4.3	-3.1	12.2	2.6	7.8	0.6
Business Fixed Investment	-1.5	14.4	-3.8	6.7	6.8	6.1	4.8	6.6	3.7	19.8	6.6	5.5	5.0
Equipment	-5.6	16.7	-3.7	6.9	8.4	5.1	6.5	6.6	3.7	21.5	5.8	6.1	4.7
Structures	9.8	8.8	-3.8	6.1	2.8	8.6	0.6	6.6	3.6	15.6	8.5	3.9	5.7
Exports	-8.9	-15.2	0.3	6.8	7.9	11.7	15.8	18.2	19.7	4.7	-4.1	7.4	15.8
Real Net Exports (72$B)	-28.4	-33.8	-38.4	-37.3	36.4	-34.6	-31.7	-28.1	-23.6	-15.0	-34.5	-32.7	-19.3
Imports	32.2	-0.7	11.1	2.7	4.1	5.2	5.7	6.4	6.1	27.0	8.3	4.9	5.7
Government Purchases	0.6	-0.3	40.9	-2.0	0.4	3.5	4.2	3.1	2.6	3.5	10.5	5.4	2.5
Real Final Sales	-0.3	4.6	5.7	0.8	4.1	3.9	3.9	3.9	3.3	6.0	3.5	3.6	3.4
Industrial Production	0.7	2.0	3.2	0.4	5.2	6.4	6.4	7.9	6.6	10.6	2.5	4.4	6.3
Change in Business Inventories (72$B)	19.1	8.3	2.5	9.5	8.5	9.1	10.7	13.7	17.1	24.8	9.9	10.5	20.3
New Car Sales (total, mill.)	11.2	11.0	12.7	9.9	11.4	11.5	11.7	11.9	11.8	10.4	11.2	11.6	11.7
New Domestic Car Sales (mill.)	8.5	8.2	9.4	6.8	8.2	8.2	8.2	8.3	8.2	8.0	8.2	8.2	8.1
New Housing Starts (total, mill.)	1.8	1.8	1.7	1.7	1.8	1.8	1.8	1.8	1.8	1.8	1.8	1.8	1.8
EMPLOYMENT, WAGES AND PRICES													
Civilian Unemployment Rate (%)	7.3	7.3	7.1	7.0	7.0	6.8	6.6	6.3	6.1	7.5	7.2	6.7	5.9
Compensation	5.0	3.5	3.7	3.5	4.3	4.1	4.1	4.3	4.7	4.2	3.9	4.0	4.5
Productivity	-3.3	1.1	1.5	2.3	1.5	1.4	1.3	1.5	1.1	2.7	0.3	1.6	1.1
Unit Labor Costs	8.6	2.4	2.1	1.2	2.8	2.7	2.9	2.8	3.6	1.4	3.6	2.4	3.4
Consumer Price Index	3.3	4.2	2.4	2.9	3.6	3.6	3.6	4.2	4.3	4.3	3.4	3.4	4.0
Implicit GNP Deflator	5.4	2.6	2.3	3.8	3.0	3.4	3.3	3.4	3.9	3.8	2.7	3.2	3.5
Prime Interest Rate (%)	10.5	10.2	9.5	9.5	9.1	8.9	8.8	8.7	8.6	12.0	9.9	8.9	8.0
3-mos. Treasury Bill Rate (%)	8.2	7.5	7.1	7.1	7.1	6.7	6.6	6.6	6.5	9.5	7.5	6.6	6.0
Corporate Bond Rate (%)	12.3	11.6	11.0	10.8	10.3	10.0	9.7	9.5	9.3	12.7	11.4	9.9	8.9
Real Personal Disposable Income	-1.6	8.1	-4.3	2.6	3.3	2.2	2.2	2.1	4.1	6.7	2.2	2.0	2.6
Profits from Current Production ($B)[1]	207.0	214.9	233.3	237.6	242.1	250.8	252.5	258.1	262.6	195.9	223.2	250.9	267.5
GOVERNMENT FISCAL POLICY ($B)[2]													
Unified Receipts										666.0	736	788	860
Unified Outlays										842.0	937	980	1035
Unified Deficit										-176.0	-201	-192	-175

[1]After-tax corporate profits with inventory valuation and capital consumption adjustments.

[2]Unified budget figures on a fiscal year basis. 1985 data are actuals.

SOURCE: U.S. Chamber of Commerce, Forecasting Section, using the Washington University model of the U.S. economy.

FORECAST ASSUMPTIONS

This month's forecast contains the Commerce Department's revision to the National Income and Product Accounts for the third quarter of 1985. Congress is assumed to enact a deficit reduction package which results in a static reduction in federal government outlays of $44 billion in fiscal year 1986 and $684 billion in fiscal year 1987. The nation's money supply, as measured by M(1), rises by almost 9 percent in 1985, 8 percent in 1986 and 7 percent in 1987. The price of a barrel of imported crude oil averages $25 in 1986 and $24 in 1987 compared to $28.9 in 1984. The trade-weighted exchange value of the dollar rises 3.5 percent this year on a year-over-year basis. During 1986 and 1987, it falls by 14 percent and 5 percent, respectively.

Total housing starts for the first two months of the fourth quarter average 1.66 million units. Starts are estimated to average 1.8 million for 1985 as a whole, similar to 1984's level of starts. In spite of the slowdown in first quarter GNP growth, the housing market has been able to maintain a very healthy level of starts, consistent with demographic and replacement demand. Nevertheless, the rebound to higher levels that had been anticipated as a result of improved affordability has not materialized. We expect that the current pace of housing activity will be continued during the next two years.

Another positive sign is the upward revision to the leading indicators index for September, which posted a 0.4 percent rise rather than the 0.1 percent increase originally reported. In October, the leading indicators registered a further 0.3 percent increase, presaging further strength in the months to come.

The nonresidential investment sector has been marked by a see-saw pattern during 1985, reflecting the uncertainty resulting from the likelihood of the enactment of a tax reform program which will substantially reduce investment incentives. Nonresidential investment fell by 1.5 percent during the first quarter of this year, but rebounded sharply during the second quarter, posting a 14.4 percent increase. Revised third quarter data, however, showed a 3.8 percent shortfall in this category of investment. In spite of these recent ups and downs, nonresidential investment remains the recovery's stellar performer, having risen by 33.1 percent since the end of 1982, compared to an average increase of 20.6 percent during the past five recoveries.

Labor productivity, which declined by 3.3 percent during the first quarter of this year, posted two consecutive gains in the second and third quarters, rising by 1.1 percent and 2.1 percent, respectively. As a result, increases in unit labor costs will remain modest and help hold the line on product prices. Consumer prices will show a further deceleration in 1985, rising by only 3.4 percent compared to a 4.3 percent increase in 1984. While several factors, including moderate wage increases, low levels of capacity utilization, and, in particular, the anticipated drop of world oil prices, will help hold the line on consumer price increases, the decline in the value of the dollar is likely to offset these downward pressures. Higher import prices should contribute to a steady, albeit slow, acceleration in prices during 1986 and 1987.

The year-long decline in the foreign exchange value of the U.S. dollar continues. Since the end of February, the dollar has fallen by 25 percent against the West German mark, 22 percent against the Japanese yen, and 28 percent against the British pound. Although the decline in the dollar's value has yet to be translated into a rebound in U.S. exports, we expect that export growth will strengthen markedly by mid-1986 as the competitiveness of U.S. exports improves.

While the U.S. economy should continue to follow a path of healthy but moderate growth, the tax reform debate weighs heavily on that assessment. The article that follows presents the results of an econometric analysis of the Ways and Means proposal. While it is clear that passage of the House version into final law would significantly impair economic growth and greatly damage productive investment, it is now certain that tax reform will not be implemented until 1987, and that the Senate is likely to make major changes in the House bill. Without knowing the structure and implementation dates of the final tax bill, any 1987 forecast is subject to great change. It is also unclear as to what investor response will be after another six months of debate and uncertainty regarding capital cost recovery. Investment could be artificially stimulated if businesses believe their decisions will be "grandfathered," or it might be artificially retarded depending upon the uncertainty of tax treatment.

Passage of the Gramm-Rudman-Hollings balanced budget legislation came too late to be included in the current forecast. However, an independent study of the bill, performed by Laurence H. Meyer and Associates for the Center for the Study of American Business shows that "a smooth transition to a balanced budget...is possible." Assuming that the Federal Reserve accommodates the budget cuts required under this bill, "...real and nominal interest rates decline sharply, investment rises, the path of real GNP is unchanged, inflation is slightly higher, the dollar falls..., and the trade deficit is virtually eliminated by 1991."

The outlook under both of these fiscal policy changes depends significantly on the monetary policy response. Easier monetary policy following enactment of the tax reform proposal would mitigate its negative impact. However, it would still leave nonresidential investment on a lower path. Similarly, a move to restrictive monetary policy in the case of the balanced budget scenario worsens the economy's prospects.

Finally, as another article in this issue details, the release of the Department of Commerce's benchmark revision to the National Income and Product Accounts at the end of this time will result in significant changes to the data. Next month's issue of ECONOMIC OUTLOOK will incorporate all of the changes.

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ECONOMIC IMPACT OF THE HOUSE WAYS AND MEANS COMMITTEE TAX REFORM BILL

by
Richard W. Rahn

A recently completed econometric analysis of the House Ways and Means Committee's tax reform bill, performed for the U.S. Chamber of Commerce by the consulting firm of Laurence H. Meyer and Associates using the Washington University macro model of the U.S. economy, shows that implementation of the bill will result in significantly lower rates of economic growth.

TABLE 1

Impact of House Ways & Means Tax Reform Bill on the U.S. Economy

	Years from Implementation							
	1	2	3	4	5	6	Average Impact	Cumulative Impact
	1986	1987	1988	1989	1990	1991		
GNP								
Difference[1]	-3.0	-5.1	-14.0	-27.5	-41.5	-53.9	-24.2	-145.0
Percent[2]	-0.2	-0.3	-0.8	-1.4	-2.1	-2.7	-1.3	
Consumption								
Difference[1]	1.6	7.5	7.2	3.1	-3.3	-11.0	0.8	5.1
Percent[2]	0.1	0.6	0.6	0.3	-0.3	-0.8	0.1	
Nonresidential Investment								
Difference[1]	-4.1	-12.2	-22.0	-32.0	-40.8	-47.8	-26.5	-158.9
Percent[2]	-1.0	-5.2	-9.0	-12.4	-15.2	-17.1	-10.5	
Equipment								
Difference[1]	-3.6	-10.9	-19.4	-27.7	-34.7	-40.0	-22.7	-136.3
Percent[2]	-2.2	-6.3	-10.8	-14.6	-17.4	-19.0	-12.2	
Structures								
Difference[1]	-0.4	-1.3	-2.6	-4.3	-6.1	-7.8	-3.8	-22.5
Percent[2]	-0.7	-2.1	-4.0	-6.4	-8.8	-11.3	-5.7	
Residential Investment								
Difference[1]	-0.8	-0.4	0.4	0.1	-0.5	-1.2	-0.4	-2.4
Percent[2]	-1.3	-0.6	0.6	0.2	-0.8	-1.8	-0.6	
Exports								
Difference[1]	-0.1	-0.4	-1.2	-2.4	-4.1	-6.0	-2.4	-14.2
Percent[2]	-0.1	-0.3	-0.8	-1.6	-2.6	-3.6	-1.6	
Unemployment Rate								
Difference[3]	0.0	0.2	0.4	0.8	1.0	1.3	0.6	NA
Implicit Price Deflator for GNP								
Difference[3]	0.1	0.1	0.1	0.2	0.1	-0.2	NA	NA
Treasury Bill Rate								
Difference[3]	0.0	0.0	-0.1	-0.2	-0.3	-0.4	-0.1	NA
Corporate Bond Rate								
Difference[3]	0.0	0.0	-0.1	-0.1	-0.2	-0.3	-0.1	NA
NIA[5] Deficit								
Difference[4]	7.5	-11.7	-13.5	-18.9	-23.1	-25.3	-11.9	NA

[1]Difference from base in billions of real (1972) dollars.
[2]Percent difference from base.
[3]Percentage point difference from base.
[4]Difference from base in billions of current dollars.
[5]National Income Accounts.

Source: Laurence H. Meyer & Associates

The study estimates that the enactment of the bill would result in a cumulative decline in real gross national product of $145 billion between 1986 and 1991. The nonresidential investment sector will suffer a $158.9 billion cumulative decline as the after-tax cost of capital investment rises substantially. Most of this decline is borne by investment in producers' durable equipment which falls by a cumulative $136.3 billion over the six year period. U.S. exports are projected to fall by $14.2 billion, while consumer spending enjoys a small $5.1 billion increase.

Both the civilian unemployment rate and the federal budget deficit would rise if the House bill is enacted as currently written. In 1991, the unemployment rate will be 1.3 percentage points higher than if the bill were not enacted, and civilian employment would fall by a cumulative 4.5 million jobs. Similarly, the federal budget deficit will be $25.3 billion (current dollars) higher than under present law.

Simulation Detail

While the U.S. economy is expected to continue on a path of relatively healthy growth under current tax law, this outcome will not be achieved if the House Ways and Means tax reform bill is enacted. The bill returns to a depreciation system similar to the Asset Depreciation Range (ADR) that was in effect prior to the enactment of the Economic Recovery Tax Act of 1981. The changes in depreciation made by the Administration's 1981 tax program have been credited as being a major contributing factor to the strength of investment growth during the current recovery. Moreover, the Ways and Means proposal includes higher capital gains tax rates, corporate tax increases and other items which will reduce U.S. economic growth.

The accompanying tables and charts compare the impact of this bill on the national economy to the baseline forecast of the Congressional Budget Office (CBO). The after-tax cost of capital for equipment, residential buildings and consumer durables is expected to rise significantly if the House bill is enacted (see Table 1). Consequently, substantial declines in investment, particularly investment in producers' durable equipment, will result in significantly lower rates of economic growth and higher unemployment (see Table 2). The plan would result in average annual increases in economic activity of only 2.9 percent during the next six years compared to a projected growth rate of 3.5 percent under present law.

Detailed results of the simulation are as follows:

- Real gross national product would suffer a $145 billion cumulative loss between 1986 and 1991 than would otherwise have been the case (see Chart 1). Averaging $24.2 billion per year, the declines in economic activity range from $3 billion during the first year to $53.9 billion by the

TABLE 2

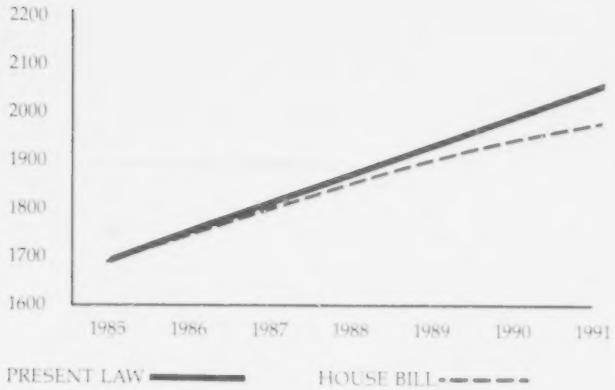
Impact of House Ways & Means Tax Reform Bill on the Rental Price of Investment (percent difference from base)

	Years from Implementation					
	1	2	3	4	5	6
	1986	1987	1988	1989	1990	1991
Business Capital						
Equipment	18.3	18.1	17.6	17.8	17.7	17.4
Structures	11.3	10.7	9.8	9.2	8.7	7.7
Residential Buildings						
Single Family	4.2	4.5	3.7	3.7	2.9	2.2
Multi Family	7.3	7.2	0.6	6.5	6.4	5.1
Consumer Durables	1.4	1.0	1.0	1.0	0.5	0.5
Inventories	1.4	0.0	-1.5	-3.2	-4.8	-5.0

Source: Laurence H. Meyer & Associates

CHART 1

IMPACT OF HOUSE BILL ON REAL GNP
(Billions 1972 $)



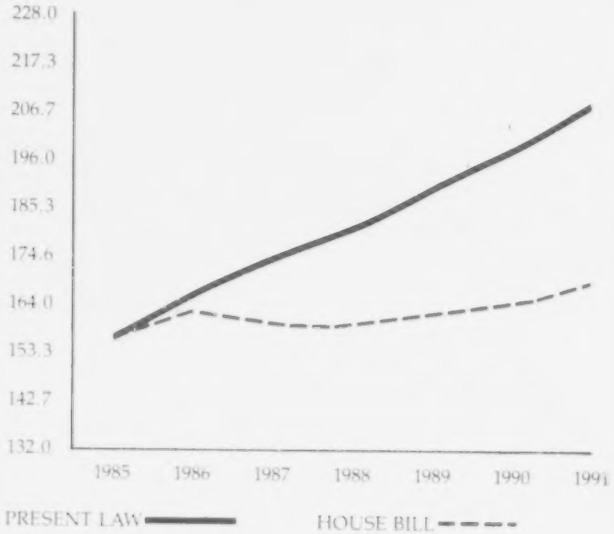
sixth year after implementation of the tax reform plan.

• Because individual tax rates would fall but the effective corporate tax rate would rise, the composition of gross national product shifts away from investment toward consumption. As a result, real consumer spending would account for 65.8 percent of total output compared to 64.6 percent under present law. On the other hand, nonresidential investment falls from 13.8 percent of total GNP under present law, to only 11.7 percent under the House bill. While consumer spending rises by a cumulative $5.1 billion during the six years following implementation of the bill, the bulk of the increase in consumption occurs during the first four years after the plan is enacted. During the fifth and sixth years following implementation of the House bill, real consumer spending falls by a cumulative $14.3 billion as the decline in investment results in higher unemployment and a lower standard of living for all Americans.

• Increases in the after-tax cost of capital investment contribute to a cumulative $158.9 billion decline in nonresidential investment during the six years following implementation of the bill. The bulk of the deterioration is borne by the producers' durable equipment sector which suffers a cumulative decline of $136.3 billion, or an average yearly shortfall of $22.7 billion (see Chart 2). Investment in nonresidential structures falls by $22.5 billion during the same period, while residential investment declines by $2.4 billion.

CHART 2

IMPACT OF HOUSE BILL ON PRODUCERS' DURABLE EQUIPMENT
(Billions 1972 $)



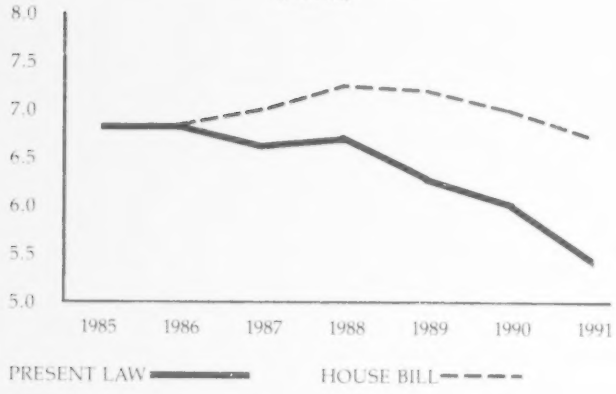
• By sharply increasing domestic capital costs and reducing domestic investment, the House bill will worsen the competitive position of U.S. goods. Consequently, real exports suffer a $14.2 billion cumulative decline between 1986 and 1981.

• The American economy's ability to create new jobs has been the envy of the industrialized world. By restricting investment, the House bill will seriously hamper the U.S. economy's ability to create new jobs. Consequently, the civilian unemployment rate is higher throughout the simulation interval (see Chart 3). In 1991, the unemployment rate is 1.3 percentage points higher than would otherwise have been the case.

• Enactment of the House bill does not have a significant impact on inflation and interest rates. The implicit deflator for GNP is approximately one-tenth of a percentage point lower under the House alternative. Similarly, both short- and long-term interest rates are, on average, only 10 basis points lower.

• The House bill will also have a negative impact on the federal deficit. Although the bill is structured to be revenue neutral on a static basis, this ignores the dynamic interaction between economic activity and government

CHART 3
IMPACT OF HOUSE BILL ON UNEMPLOYMENT RATE
(Percent)



receipts and expenditures. Lower rates of economic growth reduce the tax base, and as a result, lower receipts, while higher unemployment increases expenditures. Consequently, in 1991, the federal deficit is $25.3 billion higher than under current CBO assumptions.

Strong rates of economic growth are essential for job creation and an improved U.S. standard of living. The Ways and Means Committee bill will clearly slow the economic recovery we are now enjoying.

THE BENCHMARK REVISION TO THE NATIONAL INCOME AND PRODUCT ACCOUNTS

by
Graciela Testa-Ortiz

On December 23rd, the Department of Commerce will release its comprehensive, or benchmark revisions of the National Income and Product Accounts (NIPA). These revisions are the occasion for major changes in the data, not merely updates of previous estimates. The 1985 revisions will include statistical and methodological changes and alterations in definition and classification of several variables. All the series in the National Accounts will be revised beginning in 1973, and a substantial number of them will be revised back to 1929. What follows is a detailed description of the revisions and their likely effect on measured GNP.

Statistical and Methodological Changes: Shifting the Base Year

The statistical changes are the most important revision taking place this year. They reflect efforts to develop and update data sources and estimating techniques to deal with long-recognized shortcomings in the reporting of national income and product. The major statistical revision involves the shift in the base year period for calculating inflation-adjusted national income and product components. Heretofore, adjustment for the impact of inflation was based on 1972 prices and the 1972 composition of output. The revision will shift that base year to 1982. All the relevant constant dollar (i.e., inflation-adjusted) data will be recalculated back to 1929 in terms of 1982 prices. Fixed-weight price indices, which report price changes based on the composition of output in the base year, will also be recalculated so that weights reflect the 1982 composition of output. The fixed-weight and implicit price deflators will, from now on, have the year 1982 equal to 100. The shift from the 1972 base year to 1982 will result in more accurate measures for real output and prices. The rationale behind this shift is that economic changes since 1972 have resulted in a shift in spending patterns. In general, purchasers have shifted their preferences away from items which experienced large price increases to those which experienced smaller increases or declines in prices.

Department of Commerce calculations show that as a result of this shift, the rate of change of both GNP and the fixed-weight price index will decline. The shift in the base year will reduce the growth rate in real GNP, which averaged 2.7 percent between 1972 and 1984, by about 0.4 percentage points per year. The fixed-weight price index, which has risen at a 7.3 percent annual rate will be reduced by about 0.3 percentage points per year.

Statistical and Methodological Changes: Investment in Computers

Another statistical change includes the introduction of a price index for the deflation of computers. The lack of a deflator for computers implies that, up until now, the national income and product accounts have assumed no price change for computers (including central processors and peripheral equipment). However, preliminary evidence indicates that the prices of computers, which are included in investment in producers' durable equipment, declined at an average annual rate of over ten percent between 1970 and 1984. As a result, the inclusion of this new index, taken alone, would substantially raise the level and rate of change of producers' durable equipment *in 1972 dollars*. However, when this change is combined with the shift in the base year to 1982, the effects of these two changes are likely to offset each other.

Statistical and Methodological Changes: The Underground Economy

The major methodological change which will be made to the accounts involves improved adjustments for misreporting on tax returns. This change is expected to be quite large and to affect both the income and product com-

ponents. The underground economy is not totally ignored by the National Income Accounts, in fact, they already include an adjustment for misreporting—a major manifestation of the underground economy. The improvement which will now be implemented involves the introduction of newly available data on the extent of misreporting and nonfiling. The adjustment will be substantial. For instance, for the year 1977, it represents an $11.3 billion increase in compensation of employees, a $46.5 billion increase in proprietors' income (including inventory valuation and capital consumption adjustments), a $21.6 billion increase in personal consumption expenditures, and a $0.2 billion rise in private domestic investment.

Other data improvements include the following:

• Other labor income will be revised back to 1973 and will include a revised series on employer contributions for health insurance. This adjustment reflects a more accurate accounting of premiums paid by employers for health insurance administered by third parties and constitutes a substantial increase to this category of income.

• Improved accounting for homeownership expenses involves the inclusion of all types of expenditures considered ordinary and necessary as business deductions under federal income tax regulations. This adjustment will bring homeownership expenses into line with estimates of corporate profits and proprietors' income. The effect of this change will be to reduce rental income.

•The proprietors' income category of personal income will be adjusted to eliminate the portion of partnership income attributable to corporate partners which already appears in corporate tax returns. Without this adjustment the income of corporate partners would be counted twice, once as proprietors' income and again as corporate profits. The effect of this change is to reduce proprietors' income.

•Improved estimates of investment income of private noninsured pension plans will raise dividends received, and thus the rental income of persons. Similarly, because dividends received by these plans are netted against dividends paid, corporate profits will be reduced.

•Improved estimates of investment for electrical utilities will incorporate a new procedure that takes into account the fact that nuclear power plants have a lower share of structures and a higher share of equipment than other electric power plants. The effect of the change will be to reduce investment in structures for most years beginning in 1968.

•Improved estimates for residential investment will affect single-family housing and additions and alterations for owner-occupied dwellings. The construction value for single-family homes has been redefined to include land development done by the builder. For additions and alterations to owner-occupied dwellings, the change in methodology involves the incorporation of new data and will raise this estimate.

•At present, there exists a discrepancy in the geographic coverage of exports and imports in the GNP accounts with that found elsewhere in the national income accounts. Henceforth, these will be brought into line by excluding the Commonwealth of Puerto Rico and U.S. territories from exports and imports. The effect of this change will be to raise exports, imports, and net exports.

Changes in Definition and Classification

Changes in definition and classification are made so that the accounts will reflect the economy's evolving institutions. For example, several of the changes are intended to reflect more accurately the nature of government programs. There will be nine changes of this nature, six of which will affect total GNP. These changes include the following:

• Outlays for replacement railroad track will be added to investment in nonresidential structures, thus raising GNP.

• Outlays for replacement of major items (such as the roof or heating system) in residential buildings will be added to residential investment, raising GNP substantially.

• A social insurance fund for military retirement will be imputed. It will be included as part of employee compensation in charges against GNP, but will also be added to the national defense purchases portion of the GNP account, thus making a sizeable contribution to raising the estimate for GNP. However, because the contribution will be added to both federal receipts and expenditures, the deficit will not be affected.

• A social insurance fund for federal unemployment insurance for military personnel will be imputed. This charge will be treated as the imputed military retirement fund mentioned above, and will have no net effect upon the deficit. However, as with the military retirement fund, the resulting increase in defense purchases will raise GNP.

• The Civilian Health and Medical Plan of the Uniformed Services (CHAMPUS) will be treated as an employer-paid health insurance plan. CHAMPUS expenditures constitute an addition to employer contributions in charges against GNP and an increase in national defense purchases. Further, benefits paid under the program will be included in transfer payments in the personal income account, and reclassified from government

purchases to personal consumption expenditures for medical services in the GNP accounts. The federal deficit will not be affected by these changes.

• A bank service charge to foreigners will be imputed. This charge will be added to exports of services other than factor income and an offsetting imputed charge will be added to imports of factor income services so that net exports will not be affected. However, the portion reallocated to foreigners will be taken out of personal consumption expenditures and as a result, will reduce measured GNP.

• Military shipments financed by so-called forgiven loans will be reclassified: added to exports of goods and services and removed from national defense purchases. As a result, measured GNP will not be affected.

• Reimbursements by government to providers of medical services under several programs, including Medicaid, will be treated as transfer payments under personal income. Reimbursements to state and local hospitals will be considered fees and treated as personal nontax payments, reimbursements to other providers will be added to personal consumption expenditures for medical services and removed from state and local government purchases. Although total GNP will not be affected by this change, the composition of GNP will shift as government purchases are reduced substantially and personal consumption expenditures are increased by an equal amount.

• Payments under two state and local government assistance programs (those made to energy suppliers on behalf of low-income persons, and payments made to crime victims), will be reclassified from state and local government purchases to personal consumption expenditures within GNP.

New Tables

Changes will also be made to the national income and product account tables in order to reflect these revisions. Two new tables will be added which will provide a better accounting of the relationship between domestic output and demand, and of the increasing importance of foreign trade to the U.S. economy. One of these tables will show the relation between GNP, gross domestic purchases, and final sales to domestic purchasers. This information is designed to emphasize the relation between GNP–a measure of production–and the other two variables which represent measures of aggregate demand. Gross domestic purchases is defined as GNP less exports of goods and services plus imports of goods and services, and represents U.S. purchases of goods and services regardless of where they are produced. Final sales to domestic purchasers is defined as gross domestic purchases less the change in business inventories and represents U.S. sales regardless of where they originate.

Another new table will include command-basis GNP. This measure is defined as gross domestic purchases plus command-basis net exports. Command-basis exports is exports deflated by the implicit price deflator for imports. Thus, command-basis GNP represents gross national product adjusted for changes in the terms of trade and measures what the U.S. could purchase with its production.

Conclusion

While benchmark revisions such as the current one create major headaches for economists, particularly those of us involved in forecasting, as is obvious from the details provided, they imply a dramatic improvement to the data, and, as such, are quite welcome. However, the revisions mean that a large part of the comparative analysis that you have read in these pages will need to be revised. As a result, future issues of the OUTLOOK will re-examine such issues as the relative performance of this recovery compared to previous episodes, the composition of GNP, in particular, with regard to federal expenditures and receipts, and the investment share of total U.S. output.

THE SEARCH FOR A NEW INTERNATIONAL MONETARY SYSTEM

by
Ronald D. Utt

This last year has been a rough one for monetarist economists like ourselves who, with great confidence, predicted that the 1985 economy would be much stronger than it turned out to be. Throughout the year, our unflagging optimism followed from our belief that the rapid growth in the money supply that began in October, 1984, would lead to strong economic growth and higher rates of inflation in 1985. Although growth did pick up in the latter part of the year, it came later and was of more modest proportions than we had earlier projected.

The failure to forecast the slow growth this year is just one of several events that challenged monetarists in 1985. Another is the now near universal dissatisfaction with the existing system of flexible exchange rates–a financial arrangement advocated and supported by mainstream monetarists. Not surprisingly, this growing disenchantment has led to an aggressive search for alternatives both domestically and internationally. And as the search progresses, favorable comments are raised, often from unexpected quarters, about the advantages of a system of fixed exchange rates, and a gold-backed monetary arrangement.

The Roots of Our Current System

Our current system was born of a series of financial crises in the 1960s which came to a head in 1971 when the United States, unable and unwilling to maintain the value of the dollar at its then fixed rate, severed the last remaining link between the dollar and gold and allowed it to float on international currency markets. Within days, the dollar plunged nearly ten percent against major currencies and a new world monetary order emerged. With gold officially demonetized, the world monetary system embarked on a new series of international trade and monetary arrangements that most then believed would resolve the problems that periodically plagued the international economy as it attempted to function under a fixed rate exchange system.

Under the old system of fixed exchange rates, currencies were linked to one another by a series of fixed relationships that determined how much of one currency would purchase another. Modest variations of a few percentage points up and down were permitted but once the upper or lower limit was reached or exceeded, intervention by central banks was required as the first step in the process of restoring the established relationships. For example, if the value of a currency, say the British pound, fell against the dollar and reached its lower limit, the British and American central banks would sell dollars and buy pounds until the dollar/pound exchange rate was restored. The converse would occur if the pound rose against the dollar.

If intervention failed to restore the designated exchange rates, then more fundamental corrective actions were required. To the extent that domestic economic problems, such as inflation, were the source of the divergence from equilibrium, then the country whose currency diverged from the predetermined relationship was compelled to alter its domestic economic policies to restore the established alignment. If, for example, the depreciation of the pound against the dollar was due to a British inflation rate that exceeded that of its trading partners and led to a deterioration of the terms of trade at the existing exchange rate, then the British government would be required to adopt restrictive monetary and fiscal policies to alter the fundamentals (divergent rates of inflation) until the established exchange rates were restored. In the short run, the tighter monetary policy would cause British interest rates to rise and encourage foreigners to buy pounds to purchase pound-denominated financial instruments that were, as a result, providing attractive interest yields. By encouraging the demand for pounds, this action would lead to a rise in the pound's value. For the longer run, the tighter monetary policy would lead to lower inflation, thereby restoring the terms of trade at the original exchange rate.

If this failed to restore order, or if the needed domestic policy changes could not be made, then the declining currency would be formally devalued and a new set of equilibrium exchange rates would be established. By these mechanisms, the world monetary system functioned from the time of the Bretton Woods exchange rate accord in 1944 to 1971 when President Nixon severed the dollar's link to gold and permitted it to float freely in international currency markets.

All through this period, the United States and the dollar held a special role in world financial markets that accorded both unique privileges. Because the price of gold was fixed, rapidly expanding world trade and the need to finance it required that the dollar serve the role of a reserve currency and a key medium of exchange in most international transactions. By assuming such a role, the United States was essentially free of any requirement to maintain domestic policies consistent with a given set of exchange rates. Because a growing world economy required a growing supply of dollars, the United States could run persistent deficits in its accounts with the rest of the world without having to worry about a decline in the value of the dollar relative to the currencies of our trading partners. For much of this period, the world was eager to hold as many dollars as we were willing to supply.

While the benefits from the dollar's unique status as the world's currency were many (and also a source of friction to some of our trading partners), it was a system that imposed no discipline on our economy. As a consequence, we could engage in policies that, while harmful to our long-run economic well-being, led to no discernible problems in the short run. Whereas a persistent pattern of rising inflation and declining competitiveness would have quickly forced the British or the French to take corrective action to preserve the value of their currencies and restore their terms of trade, no such forced corrective actions confronted the United States because the excess dollars were readily absorbed by the rest of the world.

Although the dollar's value did fall in the weeks following the agreement, it is not at all clear how much of this was due to the intervention. The sum of $10 billion over a period of six weeks is not much money for a market in which U.S. banks alone trade more than $40 billion on a daily basis. Moreover, the dollar had been falling in value over the seven months prior to the September intervention. Chart one below depicts the trade-weighted value of the dollar for the last two years and notes the point of combined intervention.

Chart two depicts the value of the dollar compared to three key currencies. In each case, it is obvious that the dollar had been falling steadily well in advance of the formal intervention.

Second, if high budget deficits lead to currency overvaluation in one country, then this phenomenon should

CHART 1

EXCHANGE VALUE OF THE DOLLAR
(Trade-Weighted Average)

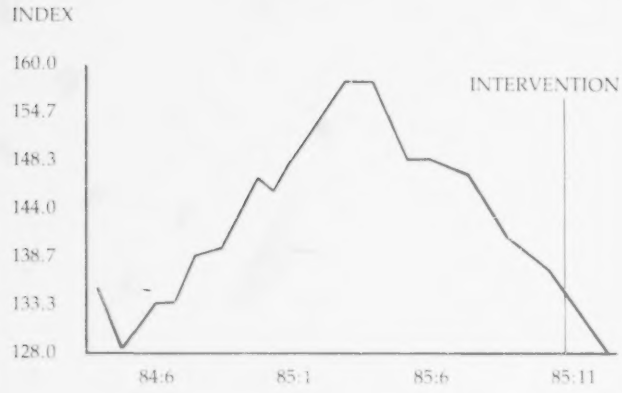
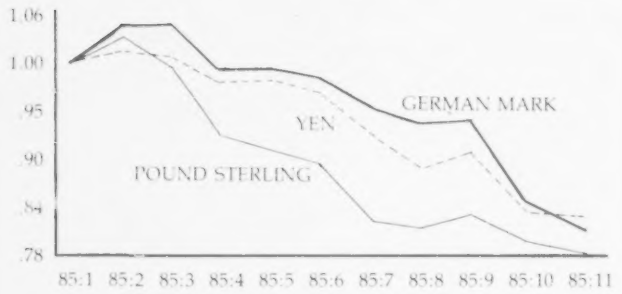


CHART 2

U.S. DOLLAR PER SELECTED COUNTRIES
(Index, 85:1 = 1.0)



be repeated in other countries where the same conditions prevail. It is not. Canada and Italy, for example, with government budget deficits that are significantly higher than ours as a share of their GNP, have seen the value of their currencies fall sharply against the dollar and other key currencies. And while the U.S. budget deficit is high by our historical standards, as a share of GNP it is not much different than the average deficit/GNP share for leading industrial countries. Thus, the facts suggest that we have to look elsewhere for the source of the problem.

The Monetary Policy Link

Dissatisfaction with the budget deficit theory of exchange rates has led many to begin a closer examination of the link between monetary policy and the value of the dollar. Inasmuch as it was the desire of the key industrial nations to maintain independent monetary policies, which they have done, such independence and divergence will lead to substantially different exchange rates over time to the extent that monetary policies differ from one another and that these differences change over time.

Looking at the last twenty years, the broad trends in the dollar's value (and other currencies as well) track inflation rates fairly well, and since inflation is a monetary phenomenon, these trends closely follow monetary policy developments too. From the late 1960s through 1980, an increasingly stimulative monetary policy contributed to accelerating inflation for much of the period. Concomitantly, as the domestic price level rose relative to that of other leading nations, the value of the dollar fell against their currencies. This trend was reversed in 1981 when the monetary brakes were applied and the U.S. inflation rate began to tumble. By 1983, the U.S. rate of inflation had fallen to less than a quarter of its 1980 rate of increase. Because this rate of improvement was far better than that of most leading industrial nations, the dollar's value reversed course and began to gain against most other currencies, peaking in early 1985 when industrial country inflation rates began to converge at the three to five percent range.

Added to these broad macroeconomic trends are a number of other financial factors that are working to keep the dollar's value high relative to other currencies. Coinciding with the rapid improvement in the domestic inflation outlook was an equally dramatic improvement in the domestic investment outlook as a result of the 1981 tax cuts and the booming economy. As economic opportunity increased at home, U.S. investors redirected their funds to the domestic economy from other parts of the globe. Our net capital outflow, which averaged over $100 billion per year in the first few years of this decade, fell to only $20 billion in 1984 for a net decline of over $80 billion. However, because the dollar serves as a reserve currency in world finance and is often the medium of exchange in trade between other countries, this massive decline in the supply of dollars led to an increase in its value as foreigners continued to demand the same amount of dollars. Something had to give, and that something was the merchandise trade deficit which soared from $40 billion per year in the late 1970s to an estimated $150 billion in 1985 in response to the highly valued dollar and the world's need for an adequate supply of dollars.

Regardless of how limited or successful the currency intervention has been, it marks an important change in U.S. attitudes toward the international exchange system and opens the way to serious consideration of even more fundamental changes in the system. The very fact that the five leading nations agreed to intervene to alter exchange values implies that they reject market-determined values and are attempting to establish a set of exchange rates more to their liking. Once this revaluation is established, it is only logical to assume that subsequent efforts will be devoted to maintaining it. And should this occur, the five nations will have established, in effect, a system of fixed exchange rates.

What is unique about this seemingly inevitable series of events is that it is occurring without any formal public discussion about alternatives for reform or whether a ma-

jor change is even desirable. Granted, the current system is creating increasingly difficult problems for major segments of our economy. Nonetheless, it is not clear whether this is due to the exchange system itself or whether other, more fundamental sources, such as budget deficits and/or monetary policy, are to blame.

The Fiscal Policy Link

One of the most commonly held views of our exchange rate problem blames the sharp rise in the dollar's value on the budget deficit and the demands it makes on U.S. financial markets. The argument runs this way: The need to finance large budget deficits raises real interest rates (the nominal interest rate less the expected rate of inflation) in the United States, and this attracts capital from around the world. The increase in the demand for U.S. assets increases the world demand for dollars and the dollar's value rises relative to other currencies. In turn, the more expensive dollar makes our exports less competitive and holds down the price of imported goods, thereby increasing the U.S. trade deficit. Finally, this gap between exports and imports supplies the world economy with the volume of dollars it demands to invest in the U.S. economy.

While intuitively plausible, the argument suffers from a number of important defects. First, there is no evidence whatsoever that budget deficits lead to high interest rates. A host of studies have been undertaken in recent years to determine the link between budget deficits and interest rates and virtually all of them have failed to find any significant relationship. Indeed, historical evidence seems to offer more support to the opposite proposition. By taking away this crucial first link, this elaborate chain of deductive reasoning falls apart.

Such an arrangement, however, could not go on forever. By the late 1960s, the dollar glut was becoming unmanageable and our trading partners were becoming increasingly resentful of our ability to avoid the need for adjustment and of our ever expanding investment in their economies which was funded with a chronically overvalued dollar. At the same time, the overvalued dollar made U.S. products increasingly uncompetitive and gave rise to an aggressive protectionist movement in this country. This system finally came unraveled when foreign central banks refused to absorb any more dollars and insisted that the United States exchange gold for the dollars they held. Unable to cover the surplus of dollars with gold, we suspended the gold/dollar link and floated the dollar. Thus ended twenty-seven years of fixed exchange rates, a system which most economists and public officials at the time were more than willing to abandon.

At the time of its demise, the general consensus was that the Bretton Woods accord was a system that had outlived its usefulness. The periodic balance of payments crises that afflicted one country or another over the period were viewed as too high a price to pay to preserve a system that was supposed to facilitate trade, not hinder it. Yet, because of the need to maintain the exchange rates and the unwillingness or inability of most countries to adopt the dramatic domestic policy changes needed to restore exchange rate equilibrium, one country after another resorted to all manner of restraints on trade and financial flows in an attempt to keep the system together. In a world trading system characterized by widely divergent public policies and equally dramatic differences in economic performance, the fixed exchange rate system of the postwar era offered no workable adjustment process to the disequilibrium that occurred with increasing frequency.

In adopting flexible exchange rates, the world moved from a system which offered few opportunities for smooth adjustment to one that was in a constant state of adjustment. As various measures of domestic economic performance among the world's trading nations diverged, the exchange rates that tied them all together adjusted effortlessly to the changes. Whereas in the past deteriorating economic performance and/or above average inflation would have forced a country into a serious balance of payments crisis and required harsh restraint on its domestic economy, the new flexible exchange rate system merely altered the exchange rates to accommodate the new realities. Thus, each country was able to pursue its own domestic policies without having to worry about international repercussions or severe balance of payments disequilibrium.

For awhile, it appeared that flexible exchange rates offered everything the world trading system could possibly want. International trade in goods and services expanded rapidly, barriers to imports declined and the pervasive system of capital controls was quickly removed. As measures of economic performance diverged, so did exchange rates, and this adjustment process allowed countries to pursue their domestic policies independent of international considerations. If one country's inflation rate was higher than the others', its exchange rate fell relative to the other currencies in order to offset the decline in competitiveness that would otherwise have followed from the higher product prices.

Although the new system clearly worked to facilitate trade and capital flows, some analysts, in the late 1970s, began to detect an unintended side effect of flexible exchange rates that was becoming every bit as menacing to the world economy as were the problems associated with the system of fixed rates. What these analysts discovered was that the severing of the balance of payments from the domestic economy removed one of the most compelling reasons for a country to act responsibly in its domestic policies. Inflation, for example, or declining competitiveness due to a hostile tax system or increased regulation,

would no longer lead to a deterioration in a country's terms of trade. If a country's products became less competitive in the world market, then its exchange rate would quickly adjust to reflect this and more or less maintain balance in its external accounts.

Looking back on the decade of the 1970s, many have come to view it as a period of license in domestic policy-making. In most countries, governments expanded their involvement in the economy and almost universally adopted inflationary monetary policies now that they were free of the balance of payments constraint. In the United States, domestic prices rose by 95 percent in the 1970s compared to 33 percent in the 1960s. And as productivity growth slowed and turned negative toward the end of the decade, unit labor costs soared. Despite all this, by the end of the decade the United States still managed to hold on to a trade surplus, in part because the trade-weighted value of the dollar declined by 27 percent over the period.

In effect, critics of the existing system argue that the advent of flexible exchange rates permitted the United States to maintain counter-productive inflationary policies for a decade longer than would have been the case under a fixed exchange rate regime. Confronted with what amounted to an international rejection of our domestic policies in the early seventies, the Nixon Administration side-stepped the need to make fundamental changes in monetary policy and, instead, floated the dollar and closed the gold window. Inflation was "attacked" by the imposition of wage and price controls, the first time such controls were imposed in peacetime. By 1973, the game plan fell apart and was followed by a severe recession and worsening inflation. A period of economic stagnation set in and was not reversed until the Federal Reserve reflated under the Carter Administration. This, in turn, led to the accelerating inflation of the late 1970s which was not reversed until the early 1980s, and then only at tremendous costs to the economy.

Although the worst of the inflation is behind us and central bankers seem to have learned to maintain a non-inflationary monetary policy, this change in policy has not led to the exchange rate stability that most expected to follow from a more stable and responsible monetary policy. Indeed, precisely the opposite has occurred. Since 1980, the value of the dollar has been even more variable against other currencies than it was during the previous decade. By one measure, the value of the dollar on international currency markets was 60 percent more variable between 1981 and 1985 than it was between 1971 and 1980.

For most of the latter period, the dollar has moved in one direction—up, and this rapid appreciation has created a great deal of hardship among American manufacturers, farmers and workers, contributed to a quintupling of our merchandise trade deficit, and turned us into an international debtor. Of course, the dollar's appreciation was not without benefits. Inflation is lower, consumers are confronted with more product choices at lower prices, and many businesses have actually benefited because of cheaper, imported factor inputs. On balance, however, the capricious nature of the distribution of costs and benefits should be viewed with alarm, and the inability to predict future currency values makes a hash of business planning and long-term investment decisions.

The Search for Solutions and the Trend Back to Fixed Exchange Rates

As severe trade-related problems confront one domestic industry after another, public officials and the business community have embarked on a search for solutions. Early on, many of the alleged solutions that were proposed involved one form of protectionism or another. Ranging from outright tariffs, to quotas, and to domestic content requirements, the focus was on protecting domestic industries and products from foreign competitors. At present, something in excess of 300 pieces of protectionist legislation have been introduced in this session of Congress. Similarly, the President has, over the past several years, used his authority under a variety of trade laws to place limits on imports of some foreign products on a selective basis. Although the protectionist solution has intense support from certain segments of the economy, most Americans recognize it for the counterproductive approach that it is.

More recently, a growing number of policy analysts have begun to focus on the system of floating exchange rates and the accompanying monetary policy as the real culprits contributing to the high value of the dollar and the impact this has had on our world trade position. After years of defending the floating rate system and justifying a hands-off attitude, the Administration, through the U.S. Treasury and the Federal Reserve, has begun to directly intervene in currency markets in an effort to diminish the value of the dollar.

On September 22, 1985, the United States, Britain, West Germany, France and Japan agreed that other major currencies should "appreciate" against the dollar and that currency market intervention and changes in domestic economic policies would be used to achieve this objective. Over the next six weeks, these nations sold more than $10 billion in an effort to lower the dollar's value. Between late September and early November, the dollar declined 13 percent against the deutsche mark and 16 percent against the yen. Supporting domestic policy changes included an increase in Japanese interest rates to further encourage the demand for yen.

At the same time, there is evidence to suggest that the demand for money (dollars) in the domestic market increased significantly during the same period. The source

of the change was the decline in the rate of inflation and the advent of regulatory innovations in the banking system which altered the public's willingness to hold money in the form of checking accounts and cash. If such a change did occur, it would have altered the otherwise predictable relationships between changes in the money supply and changes in economic growth, prices and exchange rates.

The key piece of evidence that such a shift in the demand for money has occurred is the very substantial slowdown in the growth of M1 velocity since 1982. As a measure of the turnover of the money supply to GNP in the economy, a decline in velocity indicates an increase in the demand for money. Such shifts in the demand for money are difficult to predict and can only be measured long after they have occurred. But when they do occur, they disrupt what is otherwise a stable and predictable relationship between the money supply and economic activity. Without an offsetting increase in the money supply, an increase in the demand for money can have a depressing effect on the economy. Because velocity has fallen below its trend in three of the last four years, monetary policy since 1982 may have been considerably more restrictive than the growth in the money supply indicates.

Thus, what appeared to be an expansive monetary policy since late 1984 may, in fact, have been one of restraint because increases in the money supply were quickly sopped up by increases in demand. If so, this would explain why the economy never took off in 1985 despite the apparent monetary stimulus, and why the rate of inflation continues to decline at a time when most monetarist economists expected it to increase. And finally, since exchange rates are influenced by domestic monetary policy, this also explains why the dollar rose to such lofty levels in the early part of the year and why it has declined so grudgingly since then.

Other Factors Contributing to the Dollar's Value

Like any other economic occurrence, the sharp rise in the dollar's value cannot be attributed to a single event, policy or relationship. In addition to monetary policy and whatever contribution the budget deficit may have made, other factors that have contributed to the rise include the powerful recovery in the U.S. and the investment opportunities it has created, the severe debt problems of the developing countries that have encouraged international investors to look elsewhere, the anemic recovery in much of Europe, and the faulty economic policies of several European countries which have served to depreciate their currencies against the dollar.

Conclusion

Although there is considerable debate about the causes of the extreme variability in the value of the dollar over the past several years, what is apparent from the above is that domestic policies, whether fiscal or monetary, appear to bear an important responsibility for the changes that have occurred. As a consequence, our problem may have less to do with the form of the international exchange rate system than with whatever set of domestic policies are driving the economy and the expectations about its future. Whether exchange rates are fixed or floating, a monetary policy of substantial ease or restraint will still create problems in the international accounts, as the history of the last twenty-five years amply demonstrates.

In recognition of this linkage, many of the proposals to reform the international monetary system also entail a fundamental reform of the domestic monetary system and changes in the operating procedures of the Federal Reserve Board. Covering a wide spectrum of opinion, these proposals range from the modest requirement that the Fed adhere to a price/quantity rule to proposals that would involve a return to a full-blown gold standard. In subsequent issues of the OUTLOOK, these and other proposals will be discussed in greater depth.

MANUFACTURING TRADE AND PRODUCTIVITY

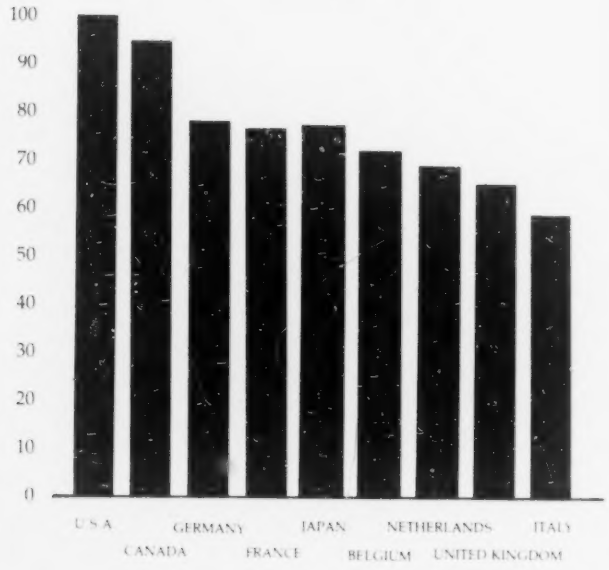
by
Martin Lefkowitz

Is America losing the productivity battle? Do Americans produce less than their counterparts in other countries? Most people would answer these questions in the affirmative, but the correct answer requires some equivocation. Americans would be surprised to learn that, as a group, we are the most productive workers in the world. Labor productivity, that is, the amount of output produced per employed person, is higher in the U.S. than in any other industrialized nation. But for some key industries, we have clearly fallen behind, and overall, other nations are gaining on us despite our recent improvements.

The reason for the prevailing misconception is twofold. First, many analysts compare relative growth rates in productivity rather than the levels of total output per worker. Secondly, international comparisons usually concentrate on the manufacturing sector which is a shrinking segment of most advanced economies. As Chart 1 illustrates, using a more comprehensive measure – GDP per employed worker – the U.S. scores the highest. Manufacturing employs only one-fifth of America's workers and is, therefore, not necessarily representative of economy-wide performance.

Although the U.S. remains in the lead, we cannot afford to be complacent because our international com-

CHART 1
GROSS DOMESTIC PRODUCT PER EMPLOYED PERSON
(percent)



petitors are narrowing the gap. This trend becomes painfully apparent when we look at changes in productivity over time.

Using the broadest measure of productivity, gross domestic product (GDP) per employed person, U.S. productivity rose at a 2.0 percent annual rate between 1950 and 1960 and at a 2.1 percent annual rate between 1960 and 1970. During the 1970s, however, growth in output per employed person slowed markedly, rising by only 1.4 percent. The slowdown in output per employed worker is even more dramatic when using 1973, the year of the first major oil price increase, as the break-point in the series. From 1960 to 1973, productivity increased at a 2.2 percent annual rate. However, between 1973 and 1984, it rose by only 0.6 percent. The impact of this slowdown was profound and can best be illustrated by the fact that 1984 GNP would have been 19.2 percent higher if productivity had continued to grow at the rate which prevailed prior to 1973.

At the same time that American productivity growth was slowing down, Japan was going through the same experience, but the decline in U.S. productivity growth was much faster than that which occurred in Japan, leading to a rapid narrowing of the gap between the two countries. Output per worker in Japan increased at three times the U.S rate in the 1950s, over four times faster in the 1960s, and five times the U.S. rate in the 1970s. As a consequence, U.S. workers who produced six times more than their Japanese counterpart in 1950, were ahead by only a third in 1980. Since then, U.S. output per employed worker has increased at a rate of 1.4 percent per year compared to an increase of 3.0 percent per year in Japan. At the current rate of change, by the year 2000, output per employed worker in the U.S. will exceed that of Japan by only about eight percent.

Why Are We Losing Ground?

What has caused these differences in productivity growth rates? One answer can be found in the amount of capital investment which has taken place in the U.S. compared to that in other industrialized countries. With the exception of the United Kingdom, the U.S. has consistently invested a lower percentage of its GNP than other major countries. Japan, in contrast, has invested more than any other nation. In the U.S., the ratio of gross fixed capital formation to GNP has ranged between 16 and 20 percent while in Japan the ratio has fluctuated between 28 and 35 percent. It is this capital formation gap which explains much of the difference in productivity performance between our two countries. Put another way, while the Japanese are currently investing about $8,000 per worker per year, Americans are investing only about $6,000 per worker.

While there are many reasons to explain the differences in investment performance, a chief one is the relative difference in the cost of capital between the U.S. and Japan. Because of a more favorable tax system, the cost of capital in Japan is estimated to be 16 percent lower than it is in the U.S. A recent study by the Institute of Political Economy estimates that if we adopted the Japanese tax system, U.S. investment would be 24 percent higher.

Further, increases in manufacturing productivity are also influenced by factors such as the mix of industries in each economy. For instance, industrial shifts from low value added industries to high value added industries result in rising productivity – a shift of workers from the textile industry to the chemical industry would automatically increase productivity in manufacturing. Measurements of labor productivity may therefore, be misleading in as much as they do not take into account these inter-industry shifts (see "The Productivity Challenge", ECONOMIC OUTLOOK, April 1985). Some of the gains in European productivity may be the result of the rapid shrinkage of low productivity industries, rather than any real advances in the manufacturing sector.

How Does America Measure Up in Manufacturing?

The deterioration in America's ability to compete in the international market for manufactured products is the most significant explanatory factor in the explosion of the trade deficit in the 1980s. The merchandise trade deficit more than tripled from $42.7 billion in 1982 to $123 billion in 1984 and could reach as high as $150 billion this year. In 1980, the U.S. had a trade surplus in manufactured goods of $18.8 billion; by 1984, it had turned into a $78 billion deficit. As Table 1 shows, this drastic widening of

TABLE 1

EXPORTS AND IMPORTS OF MANUFACTURED GOODS
(1980–1984)
($ Billions)

Year	Exports	Imports	Balance
1980	$144.0	$125.1	+18.8
1981	154.3	142.5	+11.8
1982	139.7	144.0	−4.3
1983	132.4	163.4	−31.0
1984	143.1	221.5	−78.4

Source: U.S. Department of Commerce

the deficit is the result of increased import penetration of manufactured goods rather than declining exports.

Although the rate of increase in U.S. manufacturing productivity has improved markedly since the end of the recession, it is still below that of our competitors (see Table 2). However, the gains in productivity in those countries are the result of modest increases in output accompanied by either small increases or actual decreases in employment and hours. Whereas the increase in U.S. productivity was accomplished by a surge in employment of more than eight million new jobs since the recovery began, including 1.3 million manufacturing jobs, European employment has actually declined.

TABLE 2

OUTPUT PER HOUR IN MAJOR INDUSTRIALIZED COUNTRIES
(growth rate)

Country	1973–1984	1983	1984
United States	2.0%	4.3%	3.5%
Canada	1.7	6.4	4.0
Japan	7.3	5.1	9.5
France	4.6	4.3	5.0
Germany	3.3	4.7	4.7
Italy	3.7	2.4	6.3
United Kingdom	2.3	6.7	3.9

Source: U.S. Department of Labor

Although the U.S still holds a commanding lead over Japan in total productivity per worker (see Chart 1), the gap narrows when the comparison is limited to the manufacturing sector. A study prepared by Elliot Grossman of the American Productivity Center indicates that much of the improvement in Japanese productivity has occurred in the manufacturing sector. From 1970 to 1981, the level of Japanese labor productivity in manufacturing industries rose from 49 percent to 82 percent of the American level. More significantly, output per hour in certain industries far exceeded the level of output in the U.S. As Table 3 demonstrates Japanese workers are now much more productive than their American counterparts in the manufacture of chemicals, primary metals, electrical machinery, and transportation equipment, including automobiles.

TABLE 3

COMPARISON OF ACTUAL LABOR PRODUCTIVITY LEVELS BETWEEN THE U.S. AND JAPAN–1981
(1975 U.S. Dollar Output Per Hour)

	Japan	U.S.	Japanese Output as a % of U .S.
Total Manufacturing	$ 8.68	$10.54	82.3%
Food and Tobacco	6.92	13.74	50.4
Textiles	3.20	7.64	41.9
Pulp and Paper	9.60	11.47	83.6
Chemicals	19.87	15.03	132.2
Primary Metals	19.48	13.29	146.5
Fabricated Metals	5.05	10.35	48.8
Nonelectrical Machinery	9.36	11.10	84.3
Electrical Machinery	15.85	11.32	140.0
Transportation Equipment	11.38	10.26	110.9
Other Manufacturing	5.45	8.33	54.0

Source: "Productivity and International Competition: United States and Japanese Industry", William Grossman.

Are We Losing Ground in the Manufacturing Sector?

The fact is that while much has been said of declining employment in the U.S. manufacturing sector, manufacturing employment has been declining in most developed countries for the last decade.

Table 4 indicates that, during that last ten years, U.S. productivity growth has not kept pace with other major industrial nations. The only major trading partner that we have outperformed is Canada. What is most surprising about the data is that all of the countries listed experienced declines in manufacturing employment between 1974 and 1984. But, while much has been said about the decline in U.S.manufacturing employment, the fact is that, with the exception of Japan, the U.S. experienced the smallest decline in manufacturing employment. As has been noted, the European nations have suffered substantial declines in manufacturing employment, ranging from 11 percent in Italy to 29 percent in the U.K., compared to only 1.9 percent in the U.S.

TABLE 4

COMPARISON OF MANUFACTURING PAY AND EMPLOYMENT FOR MAJOR INDUSTRIALIZED COUNTRIES

Country	Pay Per Hour ($U.S.)	Percent Change in Manufacturing Employment (1974 to 1984)	Change in Annual Output per Hour (1973 to 1984)
United States	$12.82	−1.9%	2.0%
Canada	11.51	−2.5	1.7
Japan	6.42	−0.4	7.3
France	7.23	−17.9	4.6
Germany	9.57	−16.4	3.3
Italy	7.43	−11.1	3.7
United Kingdom	5.95	−29.4	2.3

Source: U.S. Department of Labor

While international trade accounts for only about 22

percent of all goods produced in the U.S., exports account for nearly 38 percent of all goods produced in Japan. Moreover, production in certain Japanese industries is geared towards exports rather than the domestic market. For example, the American auto industry exports 7.6 percent of its total production and the U.S. imports eight times as many cars as it exports. By contrast the Japanese export 56 percent of their automobile production and import only one percent of what they export (see Table 5).

TABLE 5

EXPORTS AS A PERCENT OF JAPAN'S PRODUCTION (1984)

Product	Percent of Output Exported
35 MM Cameras	82%
Watches	84
Motorcycles	46
Video Recorders	81
Color TVs	61
Microwave Ovens	78
Electronic Calculators	79
Automobiles	56
Iron and Steel	29

Source: Japanese Ministry of Finance

A World Bank study of the composition of Japanese international trade indicates that Japanese exports are concentrated in high-wage, high-skill, capital-intensive industries, while imports are largely unskilled labor-intensive products. This marks a reversal from earlier times when the Japanese were exporting labor intensive, low capital input goods.

The combination of relatively lower rates of growth in U.S. labor productivity and the strong dollar have significantly reduced the international competitiveness of U.S. products. Yet, the data reveals that America remains the leading exporter in the free world, U.S. exports comprise about one-eighth of total free world exports. In 1984, the U.S. exported one-fourth more than Japan and twice as much as the U.K. and Italy.

The concept of comparative productivity has to be looked at in its totality. Labor productivity in the U.S. is still substantially ahead of all other major nations. The problems that we are currently experiencing are industry specific, and are concentrated in those industries where U.S. technology has fallen behind, as other nations have either adopted our methods or have enjoyed adopted technological advances larger than our own, as is the case with the steel and auto industries. To confront this challenge, the policy choices available to the U.S. are three: (1) increasing spending for research and development geared toward matching or exceeding the technological advances of other nations; (2) improving investment incentives to raise U.S. capital formation; or (3) adopting protectionist measures.

The first two alternatives are clearly the best options. Increased R&D spending will not only improve the competitive position of American industries; it also plays a significant role in increasing U.S. economic efficiency and productivity. Similarly, a low level of capital formation in the United States has been shown to be responsible for much of the lower rates of growth in U.S. productivity compared to Japan. Both private R&D spending and nonresidential investment, particularly investment in productivity-enhancing producers' durable equipment, can be significantly improved through fiscal policy measures that improve investment incentives. Clearly, as a previous article in this issue of the OUTLOOK shows, the tax reform plan now being considered is a step in the wrong direction as it would significantly reduce investment and thus, worsen the prospects for further improvements in U.S. productivity.

Although protectionist measures have been used to grant targeted industries a breathing spell in which to "catch-up "to their international competitors, the costs to U.S. consumers and the economy as a whole have been tremendous. For instance, the voluntary marketing arrangement used to "save" the U.S. automobile industry resulted in sharp increases in the price of both domestic and imported cars. Last year alone, existing protectionist laws in autos, footwear, sugar, apparel and textile, are estimated to have cost U.S. consumers $26.9 billion.

Conclusion

The performance of U.S. productivity and exports is intimately linked. Improvements in labor productivity translate into improved international competitiveness. However, the emphasis on labor productivity and manufacturing trade ignores a sector of the American economy that has been a significant source of strength, i.e., services. Measures of labor productivity only take into account one factor input and, as a result, do not measure economy-wide efficiency. The increase in service sector productivity has resulted from the more efficient use of capital rather than labor inputs. Moreover, the U.S. has experienced significant gains in international trade in services. Over the years, the U.S. has sold services such as oil management, hospital management, television programs and computer programs to the world. While the U.S. merchandise trade account suffered a $106 billion deficit last year, trade in services enjoyed a $42 billion surplus. Thus, many feel that it is in the services area that the U.S. holds its comparative advantage and should seek to open more trade in this sector.

TRENDS IN COMMERCE
NOTES ON TABLE II
DECEMBER, 1985

by
Martin Lefkowitz

Gross National Product (GNP) – The Department of Commerce's revised estimate of the nation's economic performance as measured by Gross National Product – the value of the output of goods and services – shows that the inflation-adjusted growth rate for the third quarter was 4.3 percent. This represents a $17.6 billion improvement over the second quarter. Personal consumption expenditures, residential investment and government purchases accounted for most of the third quarter increase, while net exports and a reduced rate of inventory accumulation were the major negative factors. The only major sector that declined in the third quarter was nonresidential fixed investment. Real final sales rose by $23.4 billion, or 5.7 percent.

The Services Sector – Employment in service sector establishments rose by 0.2 percent in November and is now 3.9 percent above its year-ago level. This compares with a 0.5 percent increase in employment in the goods producing sector over the last year. Over 90 percent of the job growth in the economy during the past year has been in services industries.

Consumer purchases of services which comprise 51 percent of total personal consumption expenditures, rose by 0.6 percent in October. Major domestic airlines reported that revenue passenger miles flown, that is, the number of passengers multiplied by the miles flown by each passenger, reached 24.5 billion in October, an increase of 5.2 percent from last year. For the first ten months of 1985, major U.S. carriers reported an 11 percent increase in revenue passenger miles flown compared to the same period in 1984.

Money Supply – The nation's money supply – as measured by M-1, currency in circulation plus demand deposits – decreased by 0.1 percent from September to October, compared to a 0.9 percent increase from August to September. The money supply has been growing at a 13.8 percent seasonally adjusted annual rate in the latest three month period.

Employment – The civilian unemployment rate fell to 7.0 percent in November from 7.1 percent September and October. The stickiness in the unemployment rate over the past year should not be interpreted as a sign of economic weakness but is indicative of significant and rapid growth in the labor force. Civilian employment – as measured by the monthly survey of households – increased by 60,000 persons (seasonally adjusted), following an increase of 323,000 from September to October. The number of nonagricultural payroll jobs – as measured by the monthly survey of business establishments – increased by 182,000 in November, reflecting an across the board gain, including an increase in manufacturing jobs.

Prices – The Consumer Price Index for all urban consumers (CPI-U) increased 0.3 percent in October following five consecutive months of 0.2 percent increases. The October increase was due to higher auto prices, increases in auto finance rates as dealers incentive finance plans were discontinued, and a $2.00 per gallon increase in liquor taxes. Consumer prices in October were 3.2 percent higher than their year-ago level.

Following two months of decline, finished goods wholesale prices jumped 0.8 percent in November, following a 0.9 percent increase in October. Food and automobile prices were the major factors pushing up wholesale prices for the month. From November 1984 to November 1985, the finished goods index has increased by 1.5 percent with virtually all the increase occurring in the last month.

Crude goods prices increased 2.9 percent in November, following a 3.1 percent increase in October. The November increase was largely due to a considerable rise in foodstuff prices. Crude food and feedstuff prices increased 5.8 percent in November, after advancing 6.3 percent in the preceding month. Following a drop of 0.3 percent in October, the crude energy materials index fell 0.1 percent. The index for crude nonfood materials other than energy edged down 0.2 percent, after rising 0.5 percent in October.

Housing Starts – Privately owned housing units were started at a seasonally adjusted annual rate of 1,547,000 in November, a 12 percent drop from the October level. Building permits, an indicator of future activity in the home building industry, decreased 2 percent in November but were still 2 percent above year-ago levels. Both housing starts and building permits have been fluctuating erratically in recent months and appear not to show a particular trend at this time. But most observers would be inclined to predict an increase in starts due to the continued declines in mortgage interest rates.

Industrial Production – Industrial production increased by 0.4 percent in November, following two months of decline.

The capacity utilization rate in manufacturing increased 0.2 percentage points in November to 80 percent. Motor vehicles and parts showed a significant increase in operating rates. Manufacturing capacity rose 0.7 percent in the third quarter of 1985, a 3.0 percent increase from a year ago.

TABLE II
TRENDS IN COMMERCE

	Current Period		Previous Period	Year Ago	Percent Change From Previous Period	Percent Change From Year Ago
Population (Millions) [a]	Sep/85	239.4	239.2	237.3	0.1	0.9
Gross National Product ($B)	III/85	3,915.9	3,853.1	3,694.6	1.6	6.0
Gross National Product (72$B)	III/85	1,688.9	1,671.3	1,645.2	1.1	2.7
Money Supply (M1) ($B)	Oct/85	611.1	611.9	548.3	−0.1	11.5
PEOPLE AND THEIR MONEY						
Personal Consumption Expenditures ($B)	Oct/85	2,544.2	2,567.6	2,378.1	−0.9	7.0
Personal Consumption Expenditures (72$B)	Sep/85	1,128.9	1,116.6	1,072.2	1.1	5.3
Disposable Personal Income ($B)	Oct/85	2,725.4	2,715.7	2,633.3	0.4	3.5
Disposable Personal Income (72$)	Sep/85	1,194.0	1,192.3	1,180.7	0.1	1.1
Personal Savings Rate (%)	Oct/85	2.9	1.8	6.5	1.1[b]	−3.6[b]
Civilian Employment (millions)	Nov/85	107.9	107.9	105.9	0.0	
Civilian Unemployment Rate (%)	Nov/85	7.0	7.1	7.1	−0.1[b]	−0.1[b]
Average Hourly Earnings	Nov/85	$8.67	$8.64	$8.42	0.3	3.0
Consumer Price Index (All Urban, 67 = 100) [a]	Oct/85	325.5	324.5	315.4	0.3	3.2
Purchasing Power of the Dollar (67 = $1.00) [a]	Oct/85	0.308	0.309	0.318	−0.308	−3.081
Prime Interest Rate (%) December 5, 1985		9.5	9.5	11.25	0.0[b]	−1.75[b]
Retail Sales ($)	Nov/85	115.9	114.6	110.3	1.2	5.1
SERVICES SECTOR						
Employment in Services (Millions)	Nov/85	73.7	73.5	70.9	0.3	3.9
Consumer Purchases of Service ($B)	Oct/85	1,297.1	1,288.9	1,197.9	0.6	8.3
Consumer Purchases of Service (72$B)	Sep/85	511.5	511.6	495.3	0.0	3.3
Revenue Passenger Mileage Flown Major Airlines (Billions) [a]	Oct/85	24.5	23.3	23.3	5.2	5.2
BUSINESS PROFITS AND OUTPUT						
Nonfinancial Corporate Profits ($B) [a]						
Before Tax [a]	III/85	232.8	221.0	224.8	5.3	3.6
After Tax [a]	III/85	144.7	137.4	141.7	5.3	2.1
Industrial Production (67 = 100)	Nov/85	125.1	124.6	123.4	0.4	1.4
Capacity Utilization Rate (Mfg.) (%)	Nov/85	80.0	79.8	81.2	0.2[b]	−1.2[b]
New Housing Starts (thou. units)	Nov/85	1,547.0	1,761.0	1,600.0	−12.2	−3.3
Net Business Formation (67 = 100) [a]	Oct/85	115.0	117.1	117.7	−1.8	−2.3
New Business Incorporations (Thousands)	Jun/85	55.3	56.1	54.7	−1.4	1.1
BUSINESS COSTS						
Unit Labor Costs (nonfarm) (77 = 100)	III/85	164.8	164.1	159.5	0.4	3.3
Unit Nonlabor Costs (nonfarm) (77 = 100)	III/85	158.3	158.8	154.5	−0.3	2.5
Producer Price Indices (67 = 100)						
Crude Materials	Nov/85	305.6	298.0	323.7	2.6	−5.6
Intermediate Goods	Nov/85	318.1	317.8	320.5	0.1	−0.7
Finished Goods	Nov/85	296.7	294.8	292.3	0.6	1.5
FEDERAL SPENDING AND DEBT						
Federal Spending Index (67 = 100)	Oct/85	596.9	557.3	568.5	7.1	5.0
Federal Government Debt Outstanding ($B) [a]	Jun/85	1,779.0	1,758.3	1,517.2	1.2	17.3
INTERNATIONAL TRADE						
Exports of Goods & Services ($B)	III/85	346.8	347.7	368.6	−0.3	−5.9
Imports of Goods & Services ($B)	III/85	450.8	441.6	449.3	2.1	−1.9
Balance on Goods & Services ($B)	III/85	−104.0	−93.9	−90.7	10.8	14.7
WHAT'S AHEAD?						
Index of Leading Indicators (67 = 100) [a]	Oct/85	171.1	170.6	164.2	0.3	4.2

NOTES: All data seasonally adjusted unless otherwise noted
[a] Not seasonally adjusted
[b] Percentage point difference

Productivity–Nonfarm business productivity increased at a 2.1 percent annual rate in the third quarter. Nonfarm business output grew at a 3.9 percent annual rate as a result of a 1.8 percent increase in the number of hours worked combined with the increase in productivity. Manufacturing productivity in the third quarter grew at a 3.7 percent annual rate while output rose at a 3.3 percent annual rate, reducing the number of hours worked by 0.3 percent

Interest Rates–At 9.5 percent, the prime interest rate is 1.75 percentage points below the rate at this time last year. Three-month Treasury bill rates in the first week of December were at 7.47 percent, about the same level as in early November. Thirty year Treasury stood at 9.9 percent compared to 10.12 percent during the first week of November.

Business Failures and Formations–Dun and Bradstreet's Index of Business Failures indicates that business failures in October increased by 10 percent as compared to September. Business failures in the first ten months of 1985 increased by 8.6 percent from their year-ago levels, and total business closings were up about 13.8 percent.

Dun and Bradstreet reported that 334,831 new business corporations were formed in the first six months of 1985, an increase of 2.8 percent from last year. Seven of the nine census regions reported an increase in new business corporations formed in the first six months of 1985 compared to 1984. The New England and South Atlantic regions reported the largest gains in incorporations, while the Pacific and West North Central regions reported declines in the first half of the year. There were 1.9 percent fewer new business corporations formed in June of 1985 as compared to June 1984, with 15 states actually reporting decreases of over 10 percent while only 20 states reported increases.

Federal Spending–The "Federal Spending Index," a U.S. Chamber devised measure of the monthly change in federal expenditures, increased by 5.0 percent in October compared to its year-ago level. Federal receipts, during the same period, increased by 10.8 percent due mainly to a 16 percent increase in personal and corporate income, and social insurance taxes. The data on tax receipts indicates that federal tax revenues continue to increase at a faster rate than increases in income. The larger increase in revenues than expenditures for the first month of fiscal year 1986 resulted in a $27.2 billion deficit for the first month of the year compared to $28.8 billion in FY 1985.

Personal Savings–In October, personal savings bounced back to 2.9 percent of disposable income after reaching an all time low of 1.8 percent in September. Personal consumption spending declined 0.9 percent in October, following a 1.2 percent increase in September. While consumer savings have only been increasing by an average of $137 billion per year, about 5.5 percent of income, the net value of consumers' financial assets has been increasing by more than $300 billion per year as a result of the stock market rally and increased pension fund assets. The improved financial position resulting from the appreciation of these financial assets may be helping to keep consumer spending at current high levels.

Retail Sales–Retail sales increased 1.2 percent in November following a decline of 3.3 percent in October, and a 2.1 percent increase in September. November retail sales were 5.1 percent higher than in November 1984. During the September through November period, total retail sales showed a 1.4 percent increase over the prior three-month period. Durable goods sales increased 5.8 percent from November 1984, and automotive sales increased 4.7 percent from last year's level. Nondurable goods in November increased 1.3 percent from last month and 4.7 percent over its year-ago level.

Trade Deficit–The trade deficit continued to increase in the third quarter following very large increases in the first two quarters of 1985. On a goods and services basis, the trade deficit rose to $104 billion in the third quarter, following an increase to $94 billion in the second quarter. The rise in the trade deficit can be attributed to an increase in imports, while exports fell slightly. On a balance of payments basis, the seasonally adjusted merchandise trade deficit hit a record $33.4 billion in the third quarter after. On a monthly basis, the merchandise trade deficit in October plunged to $11.5 billion from a record $15.5 billion in September. The decline in the merchandise trade deficit was the result of a lower level of manufactured imports as exports continued to stagnate. The Department of Commerce reported a $500 million drop in steel imports as a major contributing factor to the decline in the trade deficit for the month.

What's Ahead–The composite index of leading indicators, designed to predict future movements in aggregate economic activity, increased 0.3 percent in October, with six of the 11 available indicators up, while four were down, and one was unchanged. This follows a revised 0.4 percent increase for September that was previously reported as a 0.1 percent gain. October is the fifth consecutive month in which the leading indicators have increased.

SPENDING BEYOND OUR MEANS

Private and public debt in the United States adds up to a staggering $4 trillion. From this, one could easily get the impression that our society has a propensity to spend far beyond its means. Like a group of "drunken sailors" we simply lack the discipline to control our spending habits. A closer look at the statistics reveals that the situation is

not nearly as bad as it may appear. While our public spending habits most definitely require discipline, our consumer spending habits are essentially sound.

The total debt of U.S. households has increased at a rapid pace during the current upturn. With household debt now exceeding $2 trillion, the increase has rekindled concerns that households have become financially overextended. However, the data shows that the ratios of household liabilities to total assets and to total financial assets have remained fairly stable, implying that the net worth of households has risen. Further, the increase in household borrowing in the last two years has not been accompanied by a significant increase in illiquidity. Except for the short recovery period between the 1980 and 1982 recessions, growth in consumer debt has accelerated at the start of each business expansion and slowed around the start of each recession. Consumer borrowing for houses and consumer durables, therefore, is likely to rise during economic expansions when employment and income prospects are bright and fall during recessions.

While household debt trends are consistent with responsible spending habits, the enormous growth of public debt spells fiscal irresponsibility. Unlike households, the federal government has been taking an ever increasing share of our nation's output. It took over 150 years for the federal government to claim 10 percent of our gross national product (GNP) which it did in 1940. Since that time, federal expenditures have risen to almost 25 percent of GNP. This is the primary reason why we confront $200 billion deficits.

Over the last century, U.S. public spending has been rising at an annual rate almost 2 to 3 times faster than GNP. While this trend is noteworthy in itself, its ramifications can be shocking. According to some estimates, if we extrapolate the historical trend of federal expenditures into the future, federal expenditures as a percent of GNP will approach 40 percent by the year 2036. By this timetable, the actual percentage of federal expenditures for 1985 would be in the neighborhood of 24 percent, which means that the actual FY 1985 share of 24.5 percent is right on schedule!

Adding in the spending of state and local governments, total U.S. public spending is approximately 38 percent of GNP. While this percentage is formidable, one only has to look at Europe to see how far the trend towards big government can go. Public spending has now grown to 51 percent of Europe's GNP, with several governments now spending in excess of 60 percent of GNP. The results have been devastating as European economies now breed economic stagnation. With a smaller public sector in the 1960s (33 percent of GNP), real economic growth in Europe averaged a brisk 4.4 percent. However, a rising public sector has caused average real economic growth to fall to 2.5 percent for the 1975-79 period. In the 1980-84 period, real economic growth has plummeted to less than 1 percent.

Hopefully, the European experience will provide a valuable lesson for policy makers in the U.S. However, if recent experience is any guide, it looks as though we may be traveling down the same path. In spite of Congress' harangue about deficit spending, the evidence demonstrates otherwise. Federal spending has more than tripled from $267 billion in 1974 to $950 billion in 1985. Inflation adjusted spending increased at a 17.5 percent rate over the 4 years of the Carter administration and, surprisingly at the same rate during the first Reagan term. In fact, in the past 5 years, Congress has surpassed its own budget resolutions by an average of $28 billion a year. Nor is lack of tax revenues a problem, tax revenues have increased by 22 percent over the past two years, demonstrating that our deficit problem is not too few tax dollars but too much spending.

In summary, when a household makes a decision to borrow and spend, it is fully responsible for its actions. If debts pile up, households are constrained to take actions that lead to fiscal responsibility. As consumer debt rises, the consumer's ability to pay off those debts typically rises also. This is not the case in the public sector. Here, our elected representatives can gain votes by promoting extravagant and inefficient spending programs that benefit their parochial constituencies by passing the "buck" to the general public. Consequently, the general taxpayer is saddled with higher taxes and future generations bear a greater public debt burden.

PER CAPITA TAXES UP NEARLY TEN PERCENT IN 1984

The Census Bureau reported that per capita federal, state, and local government taxes in fiscal year 1984 rose 9.4 percent over 1983. Taxes collected by the three levels of government totaled $3,112 per person, showing an increase of $267 over the previous period. The federal government share of total tax revenues was 56 percent, the state government share was 27 percent, and the local government share, 17 percent.

The states which showed expenditures by state and local governments accounting for more than one-half of government spending below the federal level in 1984 were: California ($74.1 billion), New York ($65.0 billion), Texas ($35.3 billion), Illinois ($27.2 billion), Pennsylvania ($26.6 billion), Ohio ($25.4 billion), Michigan ($25.4 billion), and Florida ($23.4 billion).